**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS NUMBER: 98-0083 RST**

**Sales/Use Tax — Maintenance Contracts**
**Tax Administration — Penalty**
**For Tax Periods: 1994 through 1996**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

## ISSUES

### I. Sales/Use Tax — Service/Maintenance Agreements

**Authority:** IC 6-2.5-1-2; IC 6-2.5-2-1; IC 6-2.5-3-2; IC 6-2.5-3-4; IC 6-2.5-4-1; 45 IAC 2.2-4-2;
*Information Bulletin #2, Sales Tax* (August 1991)

Taxpayer protests proposed assessments of Indiana use tax on certain items of tangible personal property.

### II. Tax Administration — Penalty

**Authority:** IC 6-8.1-10-2; IC 6-8-10-2.1;
45 IAC 15-11-2; 45 IAC 2.2-3-20

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

## STATEMENT OF FACTS

Taxpayer sells computer hardware and peripherals. Taxpayer also provides consulting, repair, and warranty services. Among the services provided include a variety of agreements for the repair and servicing of computer equipment

Taxpayer (as vendor) entered into an agreement with a not-for-profit customer. During the life of this agreement, tangible personal property was transferred from Taxpayer to its not-for-profit customer. At issue is whether Taxpayer should have self-assessed and remitted use tax, or collected sales tax, on the tangible personal property transferred.

## I. Sales/Use Tax — Maintenance Agreements

### DISCUSSION

Taxpayer entered into a computer hardware service/maintenance agreement ("Agreement") with a not-for-profit customer ("customer"). Taxpayer did not collect sales tax on the sale of its Agreement. Neither did Taxpayer pay sales tax on parts purchased and used in maintaining and repairing its customer's computer equipment under the Agreement. Additionally, Taxpayer failed to remit use tax or collect sales tax on parts transferred.

As a result, Audit proposed assessments of use tax on the parts purchased exempt and subsequently used by Taxpayer to repair and maintain its customer's computer equipment. Audit asserts no sale of tangible personal property occurred *as the maintenance agreement was exclusively for the sale of services*. Taxpayer, therefore (according to Audit), had no obligation to collect sales tax on the repair parts. Rather, Taxpayer, as service provider, should have self-assessed and remitted use tax on the repair parts as Taxpayer was using them to fulfill its obligations under the Agreement. (See 45 IAC 2.2-4-2.)

Audit refers to *Information Bulletin #2, Sales Tax* (August 1991), which states in part:

> Any parts or tangible personal property supplied pursuant to a **nontaxable optional warranty or maintenance agreement** are subject to use tax. *The supplier of the parts or property would be liable for the use tax on the parts or property because the supplier is using the material to fulfill the service called for by the terms of the warranty or maintenance agreement.* (emphasis added).

Taxpayer disagrees. Taxpayer characterizes its Agreement as one for the sale of parts and services rather than one for services only. Taxpayer notes that among the Agreement's terms were billing rates for services to be provided and discounts for parts to be sold. Taxpayer believes its Agreement is analogous to a "time and materials" contract—a contract in which sales tax must be collected (as opposed to self-assessing and remitting use tax) on the tangible personal property transferred. Furthermore, since its customer was a not-for-profit entity with valid exemption certificates, Taxpayer contends sales tax should not have been collected anyway.

Except for certain enumerated services, sales of services are not characterized as retail transactions and are not subject to Indiana sales/use tax. IC 6-2.5-3-2. While charges for non-enumerated services are exempt from *sales tax*, a service provider must self-assess *use tax* on tangible personal property used in the performance of exempt services—unless, of course, the service provider has previously paid sales tax on these items. IC 6-2.5-3-4.

Conversely, retail transactions made in Indiana are subject to sales tax. IC 6-2.5-2-1. A retail transaction is defined generally as an activity in which a retailer acquires and subsequently sells

tangible personal property. IC 6-2.5-4-1. When service providers also sell repair or replacement parts, sales tax must be collected on the parts sold, but not on the charges for services rendered. IC 6-2.5-4-1(e) and 45 IAC 2.2-4-2.

The Department must determine whether Taxpayer should have self-assessed use tax on the tangible personal property used in fulfilling the terms of this Agreement with its not-for-profit customer, or collected sales tax on the property sold in conjunction with its sale of services. The answer, of course, depends upon the characterization of the Agreement. If the Agreement was exclusively for the sale of services, Taxpayer should have **self-assessed use tax** on the property used to fulfill its contractual obligations. But if the Agreement was for the sale of services **and** tangible personal property, Taxpayer should have **collected sales tax** on the property sold—absent issuance of any direct pay permits or exemption certificates.

In determining whether the Agreement was for the sale of parts and services, or for services only, the Department "looks" to the Agreement to identify, and characterize, what the parties have contractually agreed to.

The not-for-profit, in its search for a vendor to repair and maintain its microcomputers and related equipment, issued a request for proposals. In this request, the not-for-profit announced its intention to "purchase a maintenance program for…microcomputers, printers, plotters, scanners and other associated input and output devices…." This request also contained nineteen (19) requirements that vendors submitting proposals must meet. Among the listed requirements were the following:

- Each vendor will be responsible for providing their own storage and repair facility complete with all required outside services.
- Each vendor must be able to service all the equipment on the inventory.
- [Not-For-Profit's Designated Department] will be considered to be the point of contact for all repair calls.
- [Not-For-Profit's Designated Department] will screen service calls in an attempt to eliminate problems caused by software and/or user error.
- Each vendor must indicate on what equipment brands and/or types of devices they are certified to do warranty repairs.
- The proposal shall cover all internal boards, chips, and additional equipment contained in the various devices listed on the inventory list.
- On-site response time…shall not exceed four (4) hours or one-half (1/2) work day.
- Service for all items must be available five (5) days weekly….
- The vendor must guarantee that replacement components or items are certified to be at least equal to, or greater than, the quality of the components removed for repairs.
- The proposal shall guarantee the per item cost specified in the response will not change for the three year period of the maintenance agreement. Payment for these maintenance services will be made on July 1 of each of the three years covered in the contract.

After reviewing this request, Taxpayer responded with a proposal that was subsequently accepted by the not-for-profit (now customer). Taxpayer tendered an "Annual Service

Agreement" which incorporated, with only minor modifications, the not-for-profit's nineteen (19) requirements. The Agreement also included a "Cap & Retainer" maintenance pricing option.

> **CAP & RETAINER**
>
> | | | |
> |---|---|---|
> | 1st year | $250,000.00 | [RETAINER AMOUNT] |
> | 2nd year | $250,000.00 | [RETAINER AMOUNT] |
> | 3rd year | $250,000.00 | [REATINER AMOUNT] |
>
> This option includes $250,000.00 [the RETAINER AMOUNT] annually paid in full to [Taxpayer]. [Taxpayer] will respond to all service calls dispatched by [the Customer]. [Taxpayer] will internally invoice once a month against the $250,000.00 [RETAINER AMOUNT] until it is consumed. Once this amount is consumed, [Taxpayer] will invoice in $25,000 increments with a total ceiling cost of [CAP AMOUNT].
>
> [TAXPAYER] LABOR RATE $60.00 PER HOUR
> 10% DISCOUNT ON PARTS
>
> This option will allow [the Customer] to control the overall cost of the project. You [the Customer] will then be able to decide if the equipment is cost effective to repair or replace.
>
> [Taxpayer] will send reports with a breakdown of the services delivered and associated cost.

At first blush, the terms of Taxpayer's agreement strongly suggest *the existence of a maintenance agreement* (as that term is used in *Sales Tax Information Bulletin #2*) *exclusively for the provision of services*. The parties' characterization of the Agreement, as evidenced by language used, supports these assessments. The not-for-profit customer formally requested proposals for "Microcomputers and Related Equipment Maintenance." Taxpayer responded by submitting a document entitled "Annual Service Agreement."

Additionally, the terms tendered, and accepted, emphasize the service nature of the Agreement. Key terms discussed included payment amounts ("based on the number of units in the inventory list"), service coverage ("all the equipment on the inventory"), service availability (five days per week), on-site service response times (four hours or one-half work day), length of the Agreement ("The vendor shall respond for a three (3) year period…. Responses will not be entertained for service for less than this time period"), and payment requirements ("Payment for these maintenance services will be made on July 1 of each of the three years covered in the contract").

And finally, the "Maintenance Pricing" option ("CAP & RETAINER") chosen by the customer suggests the tender and acceptance of a maintenance agreement for services only. At the beginning of each year, the customer remits a RETAINER AMOUNT to Taxpayer. If Taxpayer's "services…and associated costs" are less than this RETAINER AMOUNT, Taxpayer enjoys a windfall. Collectively, these terms are consistent with Audit's characterization of Taxpayer's maintenance agreement as one exclusively for services.

However, the parties' performance under the contract leads the Department to a different conclusion. The parties' interpretation and subsequent performance of the contract suggest the execution of a requirements contract whereby Taxpayer (as vendor) agrees to supply a range of goods and services to the customer throughout the life of the Agreement. In return, the customer promises (at least implicitly) to acquire such goods and services exclusively from Taxpayer.

As previously noted, Taxpayer's provision of goods and services is limited by the predetermined CAP AMOUNT. Taxpayer's contractual responsibilities, therefore, terminate when the CAP AMOUNT has been reached—or upon expiration of the Agreement period. It is possible under the Agreement's terms that Taxpayer could have received a windfall if the value of the parts and services sold were less than the RETAINER AMOUNT. But such a situation never occurs because the RETAINER AMOUNT, at the customer's insistence, represents an artificially low figure. Taxpayer, therefore, profits only to the extent of the "markup" for parts and labor. And although Taxpayer receives no "windfall," Taxpayer accepts no risks. All costs associated with fulfilling the terms of the Agreement are billed to the customer.

The customer benefits as well. Convenience. Given the size and nature of its operations, it would be difficult, if not impossible, for this customer to arrange and coordinate maintenance and repair activities on an ad hoc, "as needed," basis. With this agreement, the customer receives a commitment from a qualified vendor to provide, annually, a pre-determined amount of goods and services. On-site response time, service availability, and vendor expertise are assured. Hourly labor charges and part discounts are "locked in." And consistent with the vendor's limited "windfall" opportunity, the customer cannot "profit" if costs incurred by its vendor exceed benefits received. The customer pays for all parts received and labor provided.

To summarize, the Department finds that Taxpayer's "maintenance" agreement with its not-for-profit customer does not represent the typical "nontaxable optional maintenance agreement" as discussed in *Information Bulletin #2, Sales Tax*. In this instance, Taxpayer should have collected sales tax on all tangible personal property transferred during the Agreement period. However, since the sales transactions occurred between Taxpayer and a not-for-profit customer with valid exemption certificates, Taxpayer, ultimately, was not required to collect any sales tax on these transactions.

## FINDING

Taxpayer's protest is sustained.

## II. Tax Administration — Penalty

## DISCUSSION

The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

In addition to these protested assessments, Audit proposed assessments on issues which Taxpayer conceded. With regard to both the "contested" and "non-contested" assessments, Taxpayer has provided sufficient evidence to allow the Department to conclude that the "reasonable cause" standard has been met. Consequently, the negligence penalty will be waived.

## FINDING

Taxpayer's protest is sustained.

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